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THE EFFECT OF CREATIVE ACCOUNTING ON AUDIT FAILURE: THE CASE OF MANUFACTURING COMPANIES QUOTED ON THE NIGERIAN STOCK EXCHANGE

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ABSTRACT

The Companies and Allied Matters Act (CAMA) 1990 mandates External Auditors of Companies to conduct their audit and give independent opinion on the financial statements audited by them. Users of financial statements derive substantial confidence that the accounts give a true and fair view of the financial position of the firm from such auditor's opinion. On several occasions however, such confidence have proven to be misplaced. Corporate failures and material misstatements have occurred on the hills of 'clean bill of health' opinions of auditors. Curiously, the auditors have continued to insist that the accounts actually present a true and fair view of the affairs of the entities audited and that they exercised both due care and professional diligence and skill in the conduct of the audits. Could it be that the management manipulate the accounts so carefully that the auditors remain hoodwinked throughout the audit? Essentially, manipulations of accounts to achieve nefarious objectives different from set company goals come under the purview of creative accounting. A corollary question therefore is: to what extent does creative accounting contribute to audit failure? Given that Creative Accounting is the transformation of financial accounting figures from what they actually are to what the management desire by taking advantage of the existing rules and/or ignoring some or all of them (Naser, 1993). This paper appraises the effect of creative accounting practices on audit failure in manufacturing firms in Nigeria. It adopts a survey research method polling a sample size of 200 (Taro Yameni formula) from a population of 600 senior audit staff of the big four audit firms in Nigeria and uses the Statistical Package for Social Sciences (SPSS 16 package, 2007) to test the hypothesis that : Creative Accounting has a significant positive impact on audit failure in Nigeria. This hypothesis was accepted at 5% level of significance. It was found that creative accounting practices have a positive significant effect on audit failure. The correlation coefficient R (0.616) indicates that there is a linear relationship between creative accounting practices and audit failure. The ANOVA table shows the overall significance of the model ($F = 10.987$, $P = 0.004$; $P < 0.05$. And the coefficient results are ($t = 3.796$, $B = 0.358$, $P = 0.001$; $P < 0.05$). It was therefore, recommended among other things that creative accounting practices should be legislated against and culprits held accountable.

KEYWORDS: Creative Accounting, Audit Failure, Corporate Failure and Financial Statements

INTRODUCTION

The concept of Creative accounting which may be referred to as manipulative accounting, fraudulent accounting, window dressing accounting and cosmetic accounting has no generally accepted definition. Naser (1993) defined creative accounting as the transformation of financial accounting figures from what they actually are to what the management

desire by taking advantage of the existing rules and or ignoring some or all of them. Various authors have examined the issue of management motivation towards creative accounting behavior. Hepworth (1953) identified several motivations including the existence of tax levies based on income, confidence by shareholders and workers in management that is able to report stable earnings and psychological expectations relating to increase or decrease in anticipated income. Beidleman (1973) also observed the positive effects of income smoothening on expectations, securities valuation and some element of risk reduction for analysis. They are said to be the motivating factors for creative accounting practices. Book entries are the common techniques used, for example when fictitious revenue is recognized, a book entry is used because no real transactions exist also when items in the income statement as well as the cash flow statement are reclassified, book entries are also used. Therefore, book entries are being used to achieve company's goals, as stated by Ellis and Williams (1993) that profits are not necessarily a reliable measure of a company's performance. Thy can adjust profits to suit their own purposes, management uses book entries as strategic tools and in the long run, this may harm outside stakeholders and may result in material misstatements in the financial statements. Thus when financial statements are materially misstated with the use of book entries without being uncovered by the external auditor, he may give an inappropriate opinion which makes the financial statement users to lose their confidence in the audit reports on discovery through corporate failures. In Nigeria 54 banks have either failed or been forced to close down between 1994 and 2005. Then there were the cases of the defunct liver brothers Nigeria Plc, who over stated their earnings through the cooking of the books of accounts and were appropriately sanctioned by the Security and Exchange Commission (Iwu-Egwuonwu 2011). There auditors have consistently asserted that the financial statements of these firms gave a true and fair view, but upon investigation, it was found that these firms have consistently manipulated their accounts (a practice now refers to as Creative Accounting). In the United States, failure of corporations such as Enron Corporation, Worldcom Inc., and Waste Management Inc, was also traced to creative accounting through the book entries which often go unnoticed by the auditors during their audit. Thus, it would appear that a 'properly' done audit does not guarantee that serious distortion had not occured. In a situation like this, it is not that the managers' intension is to make the firm worse off, rather they are interested in paying lower taxes and dividend, while the shareholders are interested in gaining higher dividend, then the employees to obtain better salary and the government to collect more taxes. So this conflict of interest often provides an opportunity for creative accounting practice. This is the tendency to manipulate accounting figures of the firm in other to meet the self serving objectives of the different stakeholders of the firm.

REVIEW OF RELATED LITERATURE

Amat and Gowthorpe (2003) posit that Agency theory can be said to provide solid framework for the transformation of financial accounting figures from what they actually are to what the management logic and a solid framework to understand self serving management behavior. However it may provide an incomplete theoretical basis for explaining or predicting management behavior. As observed by Horrigan (1987) the ethical dimension of human behavior may provide an important element missing from legalistic and adversarial agency relationships. According to Okoye and Aloa (2008) the informational perspective assumes that accounting disclosures have an information content that possesses value to stakeholders in providing useful signals. Taking Cadbury Nigeria Plc for instance they sacked their Managing Director and Finance Director recently on account of manipulating the company's financial records, which led to the firm of Price- water- house- coopers to review and investigate the company's accounting records. The investigation confirmed a deliberate overstatement of the company's financial position. According to the company's Public Affairs Manager, "over the number of years, Cadbury Nigeria had assigned itself an ambitious growth target".

Financial reporting communication involves a number of corporate disclosures, both mandatory and voluntary. Managers that engage in self-serving disclosure practices may do so at several levels of firm communication through creative accounting or earnings management as a result of privy information at their disposal. In a recent study, Amat and Growthorpe (2003) noted tat Managers may choose to exploit their privileged position for private gain, by managing financial reporting disclosure in their own favour. The self serving goal of the management may be achieved using a variety of strategies. For instance managers may attribute negative outcomes to uncontrollable environmental causes and positive outcomes to their own actions (Aerts, 2001; 2005; Bettman and Weitz 1983; Clatworthy and Jones, 2003)

In the extreme, managers may conceal negative outcomes completely or use thematic manipulation, selectivity, emphasis and other presentational techniques to present a positive image of the company performance (Abrahamson and Amir, 1996; Abrahamson and Park, 1994). Finally, managers may manipulate the numbers reported in the financial statements using different techniques (Healy and Whalen, 1999). Schipper (1989) also observes that creative accounting can be equated with 'disclosure management', in the sense of a purposeful intervention in the financial reporting processes. In a recent study, Stolowy (2000) see creative accounting as an assembly of procedures in order to change the profit, by increasing or decreasing, or to misrepresent the financial statements or both of them.

Some authors in the United Kingdom writing from a different perspective, have explored the issue of creative accounting as follows: Ian Griffiths, (1986) writing from the perspective of a business journalist, observes that "Every company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The figures which are fed twice a year to the investing public have all been changed in order to protect the guilty. It is the biggest con trick since the Trojan horse. In fact this deception is all in perfectly good taste. It is totally legitimate. It is creative accounting''.

Michael Jameson, (1988) writing from the perspective of the accountant, argues: "The accounting process consists of dealing with many matters of judgment and of resolving conflicts between competing approaches to the presentation of the results of financial events and transactions, this flexibility provides opportunities for manipulation, deceit and misrepresentation. These activities-practiced by the less scrupulous elements of the accounting profession – have come to be known as creative accounting. Kamal (1993) presenting an academic view, offers this definition: "Creative accounting is the transformation of financial accounting figures from what they actually are to what preparers desire by taking advantage of the existing rules and/or ignoring some or all of them.

Published financial statements having been certified to represent the true and fair view of the financial position of the reporting entity by the external auditors, provides the information needs of diverse stakeholders of the entity. However, the credibility and value of the information reported by companies is frequently questioned (Anderson et al, 2004; Hodge et al, 2006). Many reasons adduced for the practice of creative accounting, looking at the ethical perspective of this practice, both the management and the owners of firm could benefit from the practice of creative accounting. As noted by Matthew and Perere (1996), while creative in connection with accounting is often thought of as a dirty word with negative connotations, from a creativity point of view it may have positive effects if it enhances the development of accounting practice.

METHODOLOGY

This research was conducted in Nigeria and the paper adopted a survey research method, using four big audit firms in Nigeria. Data was collected using questionnaire; the questionnaire was designed to elicit information from the respondents as to the effect of creative accounting on audit failure. The survey polled a sample size of 200 (Taro Yameni

formula) from a population of 600 senior audit staff of the big four audit firms in Nigeria and used the Statistical Package for Social Sciences (SPSS 16 package, 2007) to test the hypothesis that : Creative Accounting has a significant positive impact on audit failure in Nigeria. T- test statistic was also applied at 5% level of significance.

PRESENTATION OF FINDINGS ANALYSIS AND DISCUSSION

Hypothesis Testing

H_0: Creative accounting practices do not have significant effect on audit failure.

Model Summary

Table 1: A linear Regression Analysis of the Effect of Creative Accounting Practices on Audit Failure

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.616[a]	.379	.345	1.86480

Predictors: (Constant), Creative Accounting Practices

ANOVA[b]

Table 2

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	38.205	1	38.205		
Residual	62.595	18	3.477	10.987	.004a
Total	100.800	19			

a. **Predictors:** (Constant), Creative Accounting Practices
b. **Dependent Variable:** Audit Failure

Coefficients[a]

Table 3

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	4.719	1.243		3.796	.001
Creative account Practices	.358	.108	.616	3.315	.004

a. **Dependent Variable:** Audit Failure

RESULTS

The correlation coefficient R (0.616) indicates that there is a linear relationship between creative accounting practices and audit failure. This relationship is positive and indicates that as creative accounting practices increase, audit failures also increase. In any case, the coefficient of determination R^2 (0.379), indicates that less than half the variation that exists in audit failure is explained by the model. The ANOVA table shows the overall significance of the model ($F = 10.987$, $P = 0.004$; $P < 0.05$).The study therefore rejects the null hypothesis of no significant effect of creative accounting practices on audit failure and accepts the alternative hypothesis that; creative accounting practices have positive significant effect on audit failure. Hence ($t = 3.796$, $B = 0.358$, $P = 0.001$; $P < 0.05$).

DISCUSSIONS

The study shows that creative accounting practices lead to audit failure. Hence the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated resulting to audit failure is engendered by various creative accounting practices. These practices are first and foremost carried out to make the financial statements report ‘desired’ outcomes of their preparers - top management. Essentially, audit failures occur when there are serious distortions of financial statements which are not reflected in the audit report. Since inability to resolve conflict of interests among the stake holders in the company provide the impetus for creative accounting, poor corporate governance also provide a fertile ground for creative accounting. We recall that Anderson et al, 2004 and Hodge et al 2006 maintain that management engages in creative accounting to achieve impression management which in itself is a controlling and manipulating the impression conveyed to users of accounting information. Yuthas et al (2002) see it a deliberate act to deceive and manipulate the perceptions and ultimately the decisions of stakeholders. Poor corporate governance is implicated because manipulation of the accounting records is a manifestation of absence of effective external control that creates room for opportunistic behaviors. Creative accounting engender audit risk and audit failure because majority of users of accounting information emanating from the financial statements including external auditors can hardly detect accounting manipulations due to insufficient personal skills, indifference or unwillingness to engage in meticulous analysis (Breton and Taffler, 1995).

CONCLUSIONS

This study found a strong positive relationship between creative accounting practices and audit risk which ultimately result to audit failure and in many cases corporate failure. The result is based on analysis of a 5 –point - Linker scaled questionnaire responses from a poll of the four major audit firms in Nigeria. It shows that the higher the level of creative accounting practice, the higher the audit risk. Management influenced by various reasons manipulates the information content of financial statements to beat the scrutiny of not only the ‘uniformed’ interest groups in and outside the company but also the well informed professionally - trained external auditors. Creative accounting is negative and antithetical to integrity. The established effect of creative accounting combine with the recent wave of accounting scandals that swept across USA and the rest of the world leading to public outcry of culpable negligence, recommended that auditors should ensure that they obtain sufficient evidence, exercise due diligence and professional skill to properly evaluate financial statements which may have been ‘doctored’ by management in exercise of creative accounting. Again the discovery that the avalanche of accounting principles and theories provide the latitude for creative accounting practices, make it imperative for creative accounting to be legislated against. Appropriate legal framework should be provided for the prosecution of offenders in the use of management impression to deceive stakeholders.

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